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Report from the Conference on Pooled Financing for Municipal Infrastructure

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REPORT FROM THE CONFERENCE ON POOLED FINANCING FOR MUNICIPAL INFRASTRUCTURE ORGANIZED BY THE USAID BUREAU FOR EUROPE AND EURASIA AND THE USAID OFFICE FOR DEVELOPMENT CREDITS

Bucharest, 4-6 May 2005

Representatives of the Government of Montenegro, Montenegrin municipalities, and municipal water and wastewater enterprises attended a conference on pooled financing for municipal infrastructure project organized by the USAID Bureau for Europe and Eurasia and the USAID Office for Development Credits held in Bucharest, Romania on 4-6 May 2004. Representatives of Armenia, Bulgaria, Georgia, Romania, Russia and Ukraine participated in this seminar.

Montenegro was represented by Siniša Stanković, Deputy Minister for Housing and Communal Services, Ministry of Environmental Protection and Spatial Planning; Zoran Janković, Director, Water Works Directorate of the Republic of Montenegro; Milan Lekić, Director, Pljevlja Water Works and Sewerage Public Enterprise; Dragan Nišavić, Secretary of Secretariat for Finance, Municipality of Bar; Vladan Ražnatović, Program Specialist, General Development Office, USAID/Montenegro; Savo Djurović, Program Specialist – Private Sector, Economic Policy and Reform Office, USAID/Montenegro; Michael Sinclair, Chief of Party, USAID/Montenegro Good Local Governance project implemented by the Urban Institute; Nataša Obradović, Senior Municipal Finance Advisor, USAID/Montenegro Good Local Governance project implemented by the Urban Institute; and Eileen Hoffman, Economic Growth Advisor, USAID/Montenegro Community Revitalization through Democratic Action – Economy project implemented by CHF.

This report describes the information discussed in that conference and the initial proposal for a pooled financing mechanism in Montenegro that was developed by the participants in Montenegro as part of the conference activities.

Conference topic

Financing local infrastructure represents the highest development challenge in all countries of the region. For the past few years, local authorities and communal enterprises have tried to stop the financial devastation of water supply, wastewater disposal, heating and local transport infrastructure. Rehabilitation of local infrastructure requires new investment funds that exceed the resources provided by donor agencies. Apart from this, in order to become self-sustainable local infrastructure needs access to funds from the local capital market. At the same time, there are experiences and good practices in the region where certain local governments and local communal enterprises have managed to stop and reverse the process of devastation and are increasingly becoming credit-worthy.

At the seminar, models of pooled financing systems for local infrastructures were presented. These systems create the conditions for financing communal infrastructures and other local government projects. Such pooled financing vehicles currently exist in many countries that have developed capital markets, especially in the United States. Lecturers at the seminar were USAID and US experts in this area.

POOLED FINANCING SYSTEMS FOR FINANCING LOCAL INFRASTRUCTURE

System bases

Establishing a pooled financing system is intended to provide capital for communal infrastructure projects that would otherwise be unavailable to municipal borrowers or on terms that would be more favorable to borrowers than would otherwise be available to them.

Due to the importance of the communal infrastructure issue for all regions of Montenegro, it is necessary to provide, to the greatest extent possible, the same availability of loans regardless of the size of the borrowing entity in question. The system can be established in a form of a revolving fund or in the form of a Bank (National Development Bank).

Types of municipal infrastructure financing funds

There are many types of such municipal infrastructure funds which have been developed in the USA and other countries over a long period of time. In general, they differ in the way in which they raise the funds that they then lend to municipal borrowers and in the criteria they used to allocate funds to borrowers. Three USA funds (state funds from New York, Maine, and Texas) and several funds established in the region (in Romania and Bulgaria) were presented at the seminar

In general, there are two main forms of pooled municipal infrastructure financing funds, which can be also be combined. In this report, the term “pooled financing” usually refers to both types of fund described below:

1. Revolving Fund

   Capital for in this type of municipal infrastructure financing fund is mainly provided in the form of grants from sources such as special-purpose state funds (for example, state funds for environmental projects, state funds for providing assistance to less developed municipalities etc.), grants from international financial institutions, donations, etc. The fund then lends this capital to municipal borrowers at sufficient interest to cover the fund’s operating costs and inflation, and the risk of non-payment. Sometimes, additional interest is added so that the total interest rate on the loan approaches the market rate of interest for such loans. Loans to municipal borrowers are usually made on a short- or medium-term basis. As municipalities repay the principal amount of the loans, the funds are loaned again to municipal borrowers.

2. Pooled financing fund

A pooled financing fund groups, or "pools", loans to several municipal borrowers and uses the repayment streams from those "pooled" loans to collateralize bonds issued by the pooled financing agency through the capital markets. The fund's bonds are purchased by individual and institutional investors (banks, pension funds, life insurance companies, investment funds, etc.). The pooled financing agency then lends the proceeds of the sale of its bonds to the municipal borrowers on a medium or long-term basis and uses the stream of repayment of those loans to repay the bond investors. Such funds sometimes also raise capital by borrowing from banks and international financing institutions.

Pooled financing funds usually lend to municipal borrowers on a medium- to long-term basis. They charge sufficient interest to cover their cost of capital, risk of non-payment by their municipal borrowers, and the fund's operating costs. In general, the rate of interest charged by such funds to their borrowers is lower –sometimes significantly lower – than the rate of interest that would be available to its municipal borrowers if they tried to borrow directly from banks or the capital markets. By pooling loans, such funds also reduce the transaction costs for their borrowers through economies of scale.

By spreading the investment risk of the repayment of its bonds by securing that repayment with the payment streams from several municipal loans, and by "pooling" those loans to achieve economies of scale in the financing process, the fund's municipal borrowers can expect to gain access to the capital markets, and/or more favorable borrowing terms, than they would not have achieved if each borrower had attempted to borrow on its own.

This form of municipal infrastructure financing fund works best in countries that have fairly well-developed capital markets and where the municipal borrowers are credit-worthy. However, they can also operate in countries with less-developed capital markets if they are able to gain access to the capital markets in other countries.

Municipal infrastructure funds often begin operations as revolving funds and later, when they have strengthened their capacities to assess loan proposals and credit risks and have e position at the market, sometimes evolve into pooled financing funds. Such funds also sometimes combine lending with grant-making for municipal infrastructure projects, and sometimes make both a grant and a loan for the same project.

An important aspect of both the revolving fund and the pooled financing fund is the creation of a reserve fund. In the case of a pooled financing fund, the reserve fund is sufficient to ensure that the fund can continue to pay its creditors (that is, the purchasers of its bonds or its lenders) even when one or more of the fund's municipal borrowers fail to make repayments to the fund for interest on, or principal of, their loans. This additional security for the fund's investors makes it possible for the fund to issue its bonds on the capital markets, or to borrow from institutional lenders, at rates and on terms that allow it to make loans to municipal borrowers on attractive interest rates and other terms. For revolving funds, a reserve fund provides additional capital that the fund can use to cover its operating expenses and to allow it to continue to fund new loans if one or more of its municipal borrowers fails to meet its obligations to the fund.

Other important forms of security for both revolving funds and pooled financing funds are municipal revenue and transfer payment intercept mechanisms. A municipal revenue intercept mechanism involves an agreement between the municipality and the fund that all municipal revenues will be deposited in an account that is either controlled jointly by the fund and the municipality or by a trustee acceptable to both. The agreement provides that municipal revenues will be applied first to pay debt service on the loan from the fund, then to the costs of constructing and/or operating the project financed by the loan, and thereafter to all other municipal expenses. A transfer payment intercept mechanism involves an agreement among the municipality, the fund, and the Government that all transfer payments by the Government to the municipality (including equalization grant payments and transfers of personal income taxes, natural resource concession fees, and other shared taxes, fees, and charges) will be deposited in an account that is either controlled jointly by the fund and the municipality or by a trustee acceptable to both. The agreement provides that these transfer payments will be applied in the same priorities as those provided in a municipal revenue intercept agreement.

In addition to making loans and sometimes (in the case of revolving funds) grants, both types of fund sometimes offer other services to municipal borrowers, such as credit guarantees for municipal infrastructure loans by other lenders or technical support to borrowers for project feasibility studies and preparation of loan or grant applications. The funds usually charge fees for such services, and those fees may sometimes be lower than the market rate for such services.

It should be pointed out that the experience shows that such funds are developed gradually. In the state of Maine (which has about 1.2 million inhabitants and is, therefore, somewhat similar in population to Montenegro), the municipal infrastructure fund is established in a form of pooled financing fund. When it was established in the 1960s, its initial capital available for lending was about $100 million; since then, it has loaned about $3 billion to municipal borrowers for infrastructure and environmental projects.

Fund operations

The borrowers from municipal infrastructure funds are typically municipalities or municipal enterprises. When applying for a loan, the borrower must demonstrate that the proposed project is financially sustainable (that is, that the project and/or the borrower will have sufficient revenues to cover all of its operating, maintenance, and capital costs and to repay the loan on time and in full); that the project is properly designed to serve the purpose for which it is intended; that its project construction and operating cost and estimates are accurate; that the contractor that will build the project is competent and financially reliable; and that the project will be environmentally sustainable. Borrowers are also often expected to demonstrate to the fund that the proposed project is part of a reasonable and well-developed multi-year capital investment plan.

In addition, in order to provide for the sustainability of the system, it is extremely important to establish full transparency of the fund's work, to maintain mutual trust among all participants.

In the USA, the pooled financing mode has successfully raised capital for more intensive execution of communal infrastructure. In a capital market as broad and well-developed as the one in the USA, the bonds issued by such funds are generally considered by credit rating agencies and investors to be relatively secure investments. In the US, the relatively lower rate of interest on these bonds compared to other, comparably risky investments of similar duration (for example, corporate bonds) is compensated for by the fact that the interest on the bonds paid to the investors is exempt from federal, and sometimes state, income taxation. However, this system of tax exempt interest is uncommon in other countries, and compliance with the legal requirements for the interest on the bonds to be tax-exempt adds significantly to the complexity and cost of issuance of the fund's bonds and, therefore, to the cost of borrowing by municipalities. Many economists also believe that this tax exemption unwisely distorts investment decisions.

Fund organization

In organizing such Fund, apart from the staff (in the USA, some funds have only five employees and some have dozens of employees), some of the important management groups and experts required for its operation are the following:

- a Managing Board that determines the Fund's lending, financial, and operating policies, oversees its operations, and appoints its Executive Director;
- an Advisory Body or Loan Committee that decides on whether to approve specific loan applications;
- a staff that reviews loan applications, makes recommendations to the Advisory Board regarding approval of loans, oversees the implementation of loans, and undertakes other fund operations; and
- independent firms and consultants that provide technical support to the fund based on partnership relations between public and private sectors, including financial, engineering, and environmental analyses; project implementation monitoring; banking services, etc.

APPLICABILITY OF THE POOLED FINANCING SYSTEM IN MONTENEGRO

Current situation in the communal services area in Montenegro

For a long period of time, there has not been any construction of communal infrastructure facilities in Montenegro, especially in the area of water supply; waste water collection, disposal, and treatment; and solid waste treatment and disposal. Therefore, most of the urban parts of municipalities are currently facing problems in these areas. These problems are especially evident in the lack of facilities for disposal of all kinds of waste; the poor state of sewerage infrastructure, with a relatively small percentage of residential and business structures connected to the network in urban areas; the lack of wastewater treatment plants; large losses in the water supply network; inadequate systems for water supply in rural areas, etc.

Therefore, the Ministry of Environmental Protection and Spatial Planning, with financial support from the European Agency for Reconstruction, has prepared Strategic Plans for Development of the Waste Water and Solid Waste Disposal sectors. Preparation of a Master Plan for Water Supply on the Montenegrin Coast is underway, with support from KfW Bank. The strategic planning teams that have been working on defining the activities that need to be undertaken in the next 25 years have taken into consideration all the relevant elements that significantly influence the feasibility of those plans and the dynamics of their realization. Data show that Montenegro will definitely have to provide about €1 billion in the following twenty-five year period for the realization of all the activities referring to the construction of the facilities and procurement of the equipment necessary for managing solid waste and wastewater and supplying water.

Pursuant to the existing laws and regulations, water supply and wastewater and solid waste management are the responsibilities of municipalities. Municipalities should, within their own capacities and through their own agencies and public enterprises, provide conditions for efficient realization of the above-mentioned Master Plans. Unfortunately, human resources and technical capacities in most municipalities are insufficient for them successfully to complete such difficult tasks.

Advantages and problems in the implementation of a pooled financing fund under the existing conditions in Montenegro

<u>Advantages</u>

The fund would provide loans for municipal communal infrastructure projects that would otherwise be unavailable to municipal borrowers or on terms that would be more favorable to borrowers that would otherwise be available to them

Montenegro has practically emerged from the period when it can expect to receive relatively large grants or loans on “soft” terms from the international community. The Republic will soon face a situation in which loans would be mainly provided only under the terms prevailing in the capital markets. Establishing a pooled financing fund would enable municipalities to borrow for municipal infrastructure projects on a medium- and long-term basis on terms that they would otherwise be unable to obtain.

The fund could support necessary changes and reforms by municipalities and municipal enterprises in organizing communal services and in managing their operations, and could support those reforms with loans, grants, and technical assistance.

The financial incentives offered by the fund through loans and grants to municipalities and municipal borrowers can support the implementation of priority investments and projects called for by communal services master plans adopted by the Government and better compliance with the requirements of existing and future communal services, environmental, local governance, and other Montenegrin laws.

A functioning pooled financing fund would contribute to the strengthening of the capital market in Montenegro.

After a period of operation as a revolving fund, the fund could evolve into a pooled financing fund and begin to issue bonds on the Montenegrin capital market. The existence of these bonds as an investment vehicle in Montenegro will contribute to the development of a broader, more diversified capital market and will offer another investment option that will be available to purchasers such as pension funds, life insurance companies, banks, investment funds, and individuals. A broader and deeper capital market in Montenegro will benefit all institutions that issue securities in that market.

Problems:

Guarantee mechanisms to protect the rights and interests of the fund as a creditor, and of the purchasers of the fund's bond, are currently insufficient.

Municipalities in Montenegro often take loans that they are unable to repay, and take advantage of their ability to delay payment without suffering any adverse legal or financial consequences. The ability of creditors to enforce the municipality's obligations is quite limited. This situation has unfortunately created significant distrust between municipalities and potential lenders.

Montenegro lacks experience in the operation of a pooled financing system and has an inadequately developed institutional framework (regulations, technical and personnel capacities) for the efficient functioning of such a system.

These problems were present at first in most countries that decided to establish pooled financing systems. However, these countries were able to establish the basic, minimum conditions for the fund's operation after a few years, and to gain experience and further develop and improve the institutional framework over time. The development of this institutional framework also brought great benefits to the development of other sectors of the economy through a more developed capital market, improved delivery of communal services to households and business, and better environmental conditions.

Potential organizational structure of a pooled financing system in Montenegro

Based on the previous discussion, it would be worthwhile to analyze seriously the possibility of, and requirements for, establishing a pooled financing system for communal services projects in Montenegro infrastructure objects.

The proposal by the Montenegrin participants in the 4-6 May 2005 pooled financing workshop in Bucharest is as follows:

- The fund should be established by the Government of Montenegro, with the participation of the representatives of municipalities, municipal water and wastewater and communal service enterprises, local business communities, the financial sector (banks, life insurance companies, pension funds, etc.), the general public, and other potential beneficiaries and stakeholders.
- The fund should initially be established as a revolving fund. The fund's initial capital would be provided from the proceeds of the privatization of Government-owned enterprises and from funds that the Government currently provides to municipalities to support infrastructure and development projects, environmental fees, and/or other sources. International organizations and financial institutions (for example, the European Agency for Reconstruction, the World Bank, KfW Bank, USAID, World Bank, KfW Bank, etc.) should also be requested to make grants to the fund for its initial capital.
- When the revolving fund evolves into a pooled financing fund, other international financial institutions (for example, the European Bank for Reconstruction and Development, the European Investment Bank, and Council of Europe Development Bank, etc.) should be requested to provide capital to the fund by purchasing its bonds or to lend money to the fund to be on-loaned to municipal borrowers.
- As the fund gains experience as a pooled financing fund, it should begin to raise additional capital through the issuance of bonds.
- The fund would initially make loans to municipalities to finance communal infrastructure projects, especially in the water supply, wastewater treatment, and solid waste management sector. Later, the fund would also make loans to municipalities for other infrastructure projects such as roads, markets, etc.
- When the fund becomes a pooled financing fund, it would also provide grants to municipalities to finance the preparation of loan applications to the fund or for purchasing technical advice for project preparation.

A feasibility study would show in more detail how the fund would be organized, its financing sources, the steps required to provide adequate guarantees to its investors and for ensuring timely payment of debt service by its borrowers, mechanisms for monitoring the work of the fund and the realization of projects financed by the fund, relations with other state authorities and institutions, and other issues that are important for the overall sustainability of the system.

FUTURE ACTIVITIES

If this idea is considered worth pursuing, the following steps should be undertaken in the near future:

- Organize a round table discussion of pooled financing. Participants would include representatives of the Government of Montenegro, its ministries, and other Republic bodies and representatives of international organizations and financial institutions. The round table participants would discuss the acceptability of this idea, as well as readiness of the participating organizations to entities to support the establishment of the fund.
- If the results of the round table are positive, organize a meeting with the Mayors of Montenegrin municipalities in order to inform them about the possibilities, advantages and risks involved in establishing of a revolving fund.
- Next, a feasibility study should be prepared that would present the best model for a pooled financing mechanism for municipal communal services infrastructure projects, the fund's organizational scheme, potential investment sources, as well as other elements necessary for its successful operation.
- Next, if the feasibility study shows that the establishment of such a fund in Montenegro is justified, prepare and implement the necessary institutional and legal framework to allow the fund to operate.
- Next, establish the fund.